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Understanding the Draft Pillar 1 Rules Amount B

Agenda

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Amount B Mandate and Objectives

- To simplify and streamline the application of the arm's length principle to in-country baseline marketing and distribution activities with particular focus on the needs of low capacity countries.
- This simplification is aimed at enhancing tax certainty and reducing resource-intensive disputes between taxpayers and tax administrations.
- Finally to address the need of Low Capacity Jurisdictions where appropriate local market comparables through which arm's length prices can be established are not available. For most of WATAF members, this continues to be a challenge.

Transactions In scope of Amount B

a. Buy-sell marketing and distribution transactions where the distributor purchases goods from one or more associated enterprises for wholesale distribution to unrelated parties; and

b. Sales agency and commissionaire transactions where the sales agent or commissionaire contributes to one or more associated enterprises' wholesale distribution of goods to unrelated parties.

Before the application of scoping criteria, it is important to accurately delineate the transaction (finding out from the facts what exactly is the real deal) by giving consideration to the comparability factors (functional analysis, contractual terms of the transaction, business strategies of the parties, characteristics of the product and economic circumstance of the transaction). This is necessary to evaluate if each of the scoping criteria has been met.

Ultimately the determination of in-scope transactions is defined by the functions performed, assets employed and risks assumed by the parties to the transaction.

Scoping Criteria (8a)

The qualifying transaction must exhibit economically relevant characteristics that mean it can be reliably priced using a one-sided transfer pricing method, with the distributor, sales agent or commissionaire being the tested party.

Key Elements

a) Does the contribution of each party involve the use of of unique and valuable intangible?

b) Does the functional analysis reveal degree integration of their contributions such that it cannot reliably be evaluated in isolation from each other.

c) Do both parties share in the assumption of of significant economic risk?

d) Comparability will be at the level of profit level indictors and TNMM should be used.

See Section II, Part III Section C.2.2 of the TPG.

Scoping Criteria(8b): Alternative A

Alternative A. (The tested party in the qualifying transaction must not incur annual operating expenses lower than 3% and greater than 30% of its annual net sales).

Key Elements

a. This criteria acts to exclude qualifying transactions from the scope of the simplified and streamlined approach using quantitative filters.

b. These quantitative filters provide a simplified mechanism for the assessment of whether a tested party is in scope.

c. The upper bound acts as a proxy to exclude qualifying transactions from scope where the ratio of operating expenses to sales might indicate high functional intensity, suggesting that the pricing methodology in the guidance would have lower degree of reliability.

In general, the approach is applied to achieve simplification as it is not feasible to specifically and comprehensively list a set of contributions that can be applied without ambiguity as scoping criteria for the purposes of the simplified and streamlined approach, given the breadth of activities and business operations undertaken by distributors.

Calculating the Opex and Net sales should be based on three year weighted average.

Scoping Criteria(8b) Alternative B

Alternative B. (The tested party in the qualifying transaction must not incur annual operating expenses lower than 3% and greater than 50% of its annual net sales).

Key Elements

a. This criteria acts to exclude qualifying transactions from the scope of the simplified and streamlined approach using quantitative filters.

b. These quantitative filters provide a simplified mechanism for the assessment of whether a tested party is in scope.

c. The upper bound serves to remove from scope only those distributors with levels of operating expenses that may indicate anomalous or outlier results.

Scoping Criteria (9) Out of Scope Transaction(Alternative B)

For qualifying transactions that do not fall out of scope of the simplified and streamlined approach under scoping criteria 8, a qualifying transaction will nevertheless be out of scope if:

a. The tested party makes non-baseline contributions to the transaction of a manner described in section 2.3.3 of the guidelines. **(Available only on Alternative B)** The summary of section 2.3.3 is presented below:

i. Seeks to remove qualifying transactions from scope that are not already removed through the application of scoping criterion 8, in situations where the tested party makes non-baseline contributions to the controlled transaction

ii. If the non baseline activities can be reliably separated from the baseline distributor activities and priced separately, the transaction need not be out of scope, otherwise the distributor is regarded out of scope.

iii. Considering that it is not feasible to specifically and comprehensively list a set of baseline or non-baseline contributions and the existence of facts variation from case to case, the identification of non-baseline activities follows an examples-based approach. The examples should be interpreted in light of the definition of non-baseline contributions, based on the accurate delineation of the transaction. These examples are covered in paragraph 24 to 31 of the guidelines.

Scoping Criteria (9) Out of Scope Transaction (Alternative B) Non Baseline Contribution

Non-baseline contributions of the nature of technical or specialised support activities, including customisation or modification of the products distributed.

Where the distributor makes contributions of certain technical or specialised support functions, including with respect to customisation or modification of products, for third-party customers in conjunction with – and related to – the distribution of goods to those customers, those contributions may be non-baseline contributions.

The provision of technical or specialised activities is more likely to represent non-baseline contributions where the provision of those functions requires significant and specialised capabilities that are not routine services easily obtainable from independent suppliers, where the functions are necessary to enable the use of the products distributed, where the ongoing services are connected to the original sale to the customer, and where they are an integral part of ongoing customer relationships. Such functions may include contributions to the content of the additional services to be offered to customers in the markets of the distributor, the acquisition of expertise that is necessary in order to deliver those services to customers in the markets of the distributor, or the exploitation of the potential marketing and sales value of offering such services to customers in the markets of the distributor.

Scoping Criteria (9a) Out-of-Scope Transaction (Alternative B) Non Baseline Contribution

Non-baseline contributions with respect to customisation or modification of products may include assessing the necessity or benefit of undertaking customisation or modification of the products of the MNE Group for the markets or particular customers of the distributor, based on a judgement of specific market needs, determining what the customisation or modification of the products should be, and evaluating the effectiveness of the program to customise or modify the products to best serve the needs of the distributor’s markets.

However, non-baseline contributions are not merely the capability of having technical understanding of a technical or specialised product that is required to undertake core distribution activities. Moreover, these contributions do not include functions such as translations, packaging and labelling, “break-bulk,” assembly, and cutting products to order, where the customisation or modification is not material and not performed with the objective of satisfying needs specific to the markets customers it serves.

Scoping Criteria(9a) Out of Scope Transaction (Alternative B)Non Baseline Contribution

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A practical example of this would be distributors of specialised equipment's such as Turbines and Pumps in the Oil & Gas Service industry in Nigeria. The post-installation services such as the maintenance and overhauling of such equipment are non-baseline in nature.

As an example, the buy decision of such equipment by the international oil companies is very much dependent on the availability of such specialised technical services.

Scoping Criteria(9b) Out of Scope Transaction(Services exclusion)

For qualifying transactions that do not fall out of scope of the simplified and streamlined approach under scoping criteria 8, a qualifying transaction will nevertheless be out of scope if:

B1.The qualifying transaction involves the distribution of services

Scope of Exclusion

Applies to goods and does not capture the marketing and distribution of Services, though the consideration of the inclusion of digital services is currently before the IF.

Note that the requirement do distribute goods and services in terms of functions, asset and risk assumed varies widely. The application to goods is on the premise that there would be broad consistency in the overall supply chain and functional analysis with respect to goods distribution.

Scoping Criteria (9b) Out-of-Scope Transaction (Commodities Exclusion)

For qualifying transactions that do not fall out of scope of the simplified and streamlined approach under scoping criteria 8, a qualifying transaction will nevertheless be out of scope if:

B2.Qualifying transactions involving the trading, marketing or distribution of commodities are specifically excluded from scope

Scope of Exclusion

The exclusion is broad in nature and encompasses transactions involving the trading, marketing, or distribution of products of a commodity nature, whether or not they have a quoted price, and includes transactions where the commodity has undergone qualifying processing

Scoping Criteria (9b) Out of Scope Transaction(Commodities definition)

For the purposes of the simplified and streamlined approach, a commodity may be any of the following:

a. A renewable or non-renewable physical product that is primarily derived from the earth's crust, land or water. These renewable or non-renewable physical products can be manifested in a solid, liquid or gas state and take various forms such as a hydrocarbon, mineral, mineraloid and agricultural product.

b. A renewable or non-renewable physical product that has undergone qualifying processing.

c. A product that is in accordance with the definition of a commodity provided for in paragraph 2.18 of the TPG.

The scope extends to hydrocarbon, mineral, mineraloid and agricultural commodity including qualifying processing of these classes of commodities.

Scoping Criteria(9c) Non-distribution activities separate from the qualifying transaction

The tested party carries out non-distribution activities in addition to the qualifying transaction, unless the qualifying transaction can be adequately evaluated on a separate basis, can be reliably priced separately from the non-distribution activities, and meets the administrative guardrail (when annual indirect operating expenses allocated between the distribution and non-distribution businesses using allocation keys exceeds 30% of the total costs accrued by the tested party for its total activities)

Examples of Non Distribution Activities includes the following:

I. research and development

II. Procurement

III. financing,

IV. retail distribution performed above the threshold considered.(That its annual net retail sales exceeds 20% of its total annual net sales).

The most appropriate transfer pricing method.

The transactional net margin method(TNMM) is the most appropriate method for in-scope transactions based on the following:

a. In-scope distributor does not make any unique and valuable contribution to the transaction and the transaction does exhibit characteristics that could make a two sided method appropriate.

b. Net Profit Indicators are less affected by transactional differences.

c. It is simpler, more streamlined, and more practical to examine a financial indicator for only the tested party.

d. The pricing methodology in follows the guidance for establishing comparability for TNMM in the Section 2.74 to 2.81 of the TPG.

Determining the Arm’s Length Return (Pricing Matrix)

a. We agreed the appropriate method as TNMM and the In scope distributor as the tested party.

b. The search criteria as well as additional screening and qualitative review to reflect the scoping criteria has led to the development of a global dataset of about 2,000 companies involved in baseline marketing and distribution activities.

c. The financial information obtained from these global data set formed the basis of approximation of the of the arms length result which has now be translated into a pricing matrix.

d. The pricing matrix is presented in segments according to the following factors:

I. operating asset to sales intensity (OAS)

II. operating expense to sales intensity (OES)

III. industry.

Determining the Arm’s Length Return (Steps for Tax Administrators and Taxpayers)

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Step 1 - determine the relevant industry grouping of the tested party from the three possible groupings (i.e. industry grouping 1, 2 or 3) and identify the applicable vertical column of return on sales in the pricing matrix in Table 1 that correspond to that industry grouping.

Step 2 - determine the relevant factor intensity classification of the tested party from the five possible classifications (i.e. factor intensity classification A, B, C, D, and E) and identify the applicable horizontal row of return on sales in the pricing matrix in Table 1 that correspond to that factor intensity classification. The factor intensity classification of the tested party should be calculated based on a weighted average of the most recent three-year financial period

Step 3 - identify and apply the arm’s length range from the pricing matrix segment that corresponds to the intersection of the industry grouping and the factor intensity classification of the tested party

Pricing Matrix (return on sales %) derived from the global dataset.

a. Table 1: Return on sales.

Industry Grouping / Factor intensity	Industry Grouping 1	Industry Grouping 2	Industry Grouping 3
[A] *High OAS / any OES >45%/any level*	3.50% +/- 0.5%	5.25% +/- 0.5%	5.50% +/- 0.5%
[B] *Med/high OAS / any OES 30%-44.99%/any level*	3.25% +/- 0.5%	3.50% +/- 0.5%	4.50% +/- 0.5%
[C] *Med low OAS/any OES 15%-29.99%/any level*	2.75% +/- 0.5%	3.25% +/- 0.5%	4.25% +/- 0.5%
[D] *Low OAS / non-low OES <15%/10% or higher*	2.00% +/- 0.5%	2.25% +/- 0.5%	3.00% +/- 0.5%
[E] *Low OAS/low OES <15% OAS/<10% OES*	1.50% +/- 0.5%	1.75% +/- 0.5%	2.25% +/- 0.5%

Summary of Industry Grouping.

Group 1 – industry categories which have a statistically significant relationship to lower levels of return;

Group 2 – industry categories which do not show a statistically significant relationship to levels of return;

Group 3 – industry categories which have a statistically significant relationship to higher levels of return.

The categories of goods falling into each of the three industry groups are:

Group 1

Perishable foods, animal feeds, agricultural supplies, Grocery, household consumables, alcohol and tobacco, pet foods, construction materials and supplies, plumbing supplies, metal, paper and packaging.

Group 2

Domestic vehicles, IT hardware, software and components, electrical components and consumables, clothing and apparel, textiles, hides, furs, jewellery, plastics and chemicals, lubricants, dyes, home appliances, consumer electronics, furniture, home and office consumables, printed matter, mixed goods, multiple products lines, assorted supplies, any other goods and components not listed under Group 1 or Group 3.

Group 3

Medical machinery, pharmaceuticals, medical, health and wellbeing miscellaneous supplies, industrial machinery, industrial tools, industrial components and miscellaneous supplies, industrial, agricultural and used domestic vehicles, motorcycles, vehicle parts and supplies.

Addressing Geographic Difference and Country Risk Adjustment

Based on economic analysis by the Inclusive Framework, it was observed that geographic difference affects profitability of baseline marketing and distribution entities for a smaller number of jurisdiction for which data is available.

This has led to the development of a modified pricing matrix to take into the difference in profitability observed in these jurisdictions are the global data set. For such jurisdictions, the modified pricing matrix will supersede the pricing matrix from the global data set.

In addition, the data availability mechanism is also intended to address instances where there is no or insufficient dataset for a particular tested party jurisdiction but evidence exist of country risk in the jurisdiction that may influence the arm's length returns for in scope transaction.

Country risk can be defined as the risk induced by the country location of a business activity rather than the fundamental nature of the activity. This risk may derive from the political or economic environment in which that business operates.

Addressing Geographic Difference and Country Risk Adjustment (Modified Pricing Matrix) Table 2

Industry Grouping / Factor intensity	Industry Grouping 1	Industry Grouping 2	Industry Grouping 3
[A] *High OAS / any OES* *>45%/any level*	x.x% +/- 0.5%	x.x% +/- 0.5%	x.x% +/- 0.5%
[B] *Med/high OAS / any OES* *30%-44.99%/any level*	x.x% +/- 0.5%	x.x% +/- 0.5%	x.x% +/- 0.5%
[C] *Med low OAS/any OES* *15%-29.99%/any level*	x.x% +/- 0.5%	x.x% +/- 0.5%	x.x% +/- 0.5%
[D] *Low OAS / non-low OES* *<15%/10% or higher*	x.x% +/- 0.5%	x.x% +/- 0.5%	x.x% +/- 0.5%
[E] *Low OAS/low OES* *<15% OAS/<10% OES*	x.x% +/- 0.5%	x.x% +/- 0.5%	x.x% +/- 0.5%

Addressing Geographic Difference and Country Risk Adjustment

The data availability mechanism is intended to address the fact that a distributor operating in a “high country risk” jurisdiction is entitled to higher returns, relative to a distributor operating in a “low country risk” jurisdiction, all other things being equal.

Under the data availability mechanism, the sovereign credit rating of the jurisdiction represents an approximation that is used to derive this relative difference in returns.

A tested party in a qualifying jurisdiction will earn an adjusted return in accordance with the following formula:

Adjusted return on sales = UROS(TP) + (NRA(J) x OAS(TP))

where

UROS(TP)is the unadjusted return on sales percentage of the tested party calculated based on the matrix in Table 1

NRA(J) is the net risk adjustment percentage for a given jurisdiction derived from figure Table 2. where the applicable category is determined by reference to the sovereign credit rating of the jurisdiction of the tested party applicable at the time of the relevant period.

OASTP is the net operating asset intensity percentage of the tested party for the relevant period but will not exceed 85% for the purpose of computing the adjusted return on sales of the tested party.

Net risk adjustment percentage to be applied to the NOA of a Tested Party in qualifying jurisdictions. Table 3

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Sovereign Credit Rating Category		Net risk adjustment %
Investment grade	BBB+	0.0%
	BBB	0.1%
	BBB-	0.4%
Non-investment grade	BB+	0.7%
	BB	1.3%
	BB-	1.9%
	B+	2.8%
	B	3.9%
	B-	4.9%
	CCC+	6.0%
	CCC	7.6%
	CCC- (or lower)	8.6%

Application of the simplified and streamlined approach using a qualifying local dataset

There is also the approach to use local data in a bid to address any potentially material data availability gaps that may exist in the global dataset owing to lack of country coverage of the underlying commercial database used to generate the global dataset.

In this instance, a qualifying local dataset will be produced by a relevant tax administration using a similar methodology used to produce the global dataset and will be translated into a local pricing matrix that conforms to and supersedes the pricing matrix in Table 1. However, this is yet to be validated by the Inclusive Framework.

To address differences in functional profile and to ensure there is no over-compensation for entities with relatively low operating expense, a Berry Ratio cap-and-collar approach is applied as a corroborative test and guardrail within which the primary return on sales net profit indicator is applied.

Documentation

The requirement of transfer pricing documentation (three-tiered approach) is expected to meet the need of tax administrators in providing relevant information. Additional requirement by tax administrators must consider cost of compliance particularly for SMEs and be sensitive to their compliance burden.

Particular attention should be given to:

a. Functional analysis

b. Written contracts or agreements

c. Calculations showing the determination of the relevant revenue, costs and assets allocated or attributed to the in-scope transaction;

d. Information and allocation schedules showing how the financial data used in assessing the applicability of the simplified and streamlined approach and applying the transfer pricing method ties to the annual financial statements.